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# LEGAL CONSIDERATIONS OF TAX EVASION AND TAX AVOIDANCE

DÁNIEL DEÁK

The study of fiscal non-compliance – in particular, that of tax evasion – is quite extensive in the literature of economics. Lawyers do not show much interest in fiscal anomalies. An exception for this is perhaps tax avoidance which is usually interpreted as the problem of the form and substance. Apart from the modest interest in irregularities in fiscal law, the legal theories of obedience, or disobedience, and coherence have grown significantly, thanks to the precept of William Ross on *prima facie* duties or the concept introduced later by John Rawls on the reflective equilibrium. This paper is an attempt to apply the categories explored by legal philosophy to the developments of fiscal law.

**Keywords:** tax evasion; tax avoidance; *prima facie* duties; "reflective equilibrium"

Tax evasion and tax avoidance are deviations from what is to be found legal, fair and just. They occur frequently together. It is common in them that they result in losses in the tax revenue. Otherwise they are different from each other. Tax evasion is associated with breaking the law: it is a gap developed due to the taxpayers' real conduct departing from what has been promulgated as statutory fiscal law. In contrast, tax avoidance does not ensue the breaking of the law. It is yet the circumvention of law: taxpayers entangled in tax avoidance attack what can be seen as the integrity of law. In the following, the theoretical and regulatory environment of tax evasion and tax avoidance will be illuminated. Examples will mainly be taken from the Hungarian law but they can be replaced by similar examples originated from other jurisdictions.

Dániel Deák, BUESPA, Department of Economic Law, H-1093 Budapest, Fővám tér 8, Hungary.
E-mail: daniel.deak@bkae.hu

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## 1. THEORETICAL BACKGROUND

It is certainly useful, at least in principle, to assume the perfect functioning of a system of enforcing tax laws. This is first because in a normal country tax laws mean clear guidance for taxpayers in most cases and the collection of tax can apparently rest on the taxpayer compliance. Secondly, cool reasoning and a serious commitment to political democracy (to the principle of the equality before the law) and to the rule of law requires us, citizens, to believe that social systems (economic, educational, etc.), including the legal system, really work.

In addition to a scholarly assumption of perfect functioning – constituting the macro aspect of law –, there are mechanisms to complete the realisation of law in micro aspects. They are not to supersede the normal legal mechanism of the macro world, albeit conflicts between the two levels of reality cannot be precluded. There are individual situations where the instruments of the macro world of tax law do not provide taxpayers with complete guidance. In these cases, one can only hope that problems will be solved if the affected parties are able to achieve coherence in the legal instruments mobilised. Namely, they draft legal documents, or elaborate formal or informal agreements, etc.

In the following, I offer a complementary view of law because I do not think that the problem of tax avoidance and other biases could be fully understood merely established on the traditional view that inconsistencies in tax laws can inadvertently occur and that blatant abuse can simply be eliminated, once these inconsistencies will be removed from the law. Apparently, private rulings are unavoidable because the macro-level legal system is subject to correction, the means of which is called in common-law countries fairness or equity. I would like to go further and suggest that a more thorough analysis of law requires the holistic approach to law.

First tax evasion and tax avoidance will be explained from the perspective of the efficiency-based theory of law and economics. Following introductory remarks, particular consideration will be given to the obligation to obey the law, the understanding of which is central to drawing up the theoretical foundations of tax evasion as a kind of breaking the law. It will be discussed if tax evasion, as a sort of civil disobedience, can be forgiven. In addition to obedience – accentuating the micro aspect of complying with the law in individual cases –, the authority of law – associated with the macro level of a legitimate legal system and its social environment – is also worth examination. Furthermore, loyalty will also be dealt with as a micro aspect of law. As explained below, the business schemes covered by fiduciary duties can be problematic for tax purposes because of the difficulties in calculating the tax liability in the absence of transparent structures.

The abuse of law is a problem, the study of which does not seem to be hopeful from a traditional viewpoint of a correspondence theory, according to which the propositions of a theory need to be consistent with the facts of the real world. A coherence theory rests on principles consistent with each other and consists of precepts that must flow from these principles. While a correspondence theory relates to the macro mechanism of making and implementing law, a coherence theory concerns the legal world in a micro perspective (as discussed below in detail). There are macro structures where rights arranged *a priori* by the legislator do not necessarily coincide with the facts as occurred. In many cases, a solution for this problem is to bargain. This is a reaction to the macro-level problem on a micro level. In a micro perspective, it is crucial to try to reconstruct the means of communication locally, in order to comply with the coherent system of norms. In the fiscal law area, the macro relations developed during the distribution and redistribution of capital and goods can be complemented by the micro relations of bargaining (or rather private rulings) in which people are involved, while seeking to identify, and verify, their presumed tax liability.

In reviewing tax avoidance schemes, it is essential to identify the inherent logic and the authentic content of a legal system. The validity of law is a category equivalent to the micro category of the coherence of law. It is discussed below in the context of positive and natural law. In connection to the concept of the validity of law, the notion of right law will also be dealt with. For the purpose of interpreting tax avoidance or, broadly, the abuse of law, it is also important that the relevance and certainty of economic valuation and financial information can be doubtful during the proliferated processes of the separation of ownership and control, and the discrepancy between legal and economic identity. More details of it are set forth below.

## Tax evasion and tax avoidance from the perspective of law and economics

Tax evasion is not identical to the loss in the potential revenue that could be collected in the absence of tax evasion. If tax collection were more efficient, the taxpayers' conduct would not remain the same, and so the real economic circumstances for tax collection would also be different (Franzoni 1996–2000, 53). From the standpoint of law and economics at least, tax evasion is in fact a wedge between economic reality and the purely legal construction of statutory tax rates (*ibid*., 54). It is closely connected with the informal economy and associated crimes like fraud, false accounting, money laundering, bribery, etc. Tax avoidance is in principle punishable, although in many cases it is almost impossible for

the eventual public authority to verify what has been observed. Tax minimisation is frequently the direct result of the use of tax incentives. It is then hard to say if the use of incentives can be substantiated in full compliance with the principles of tax law.

The economic analysis of law suggests that tax evasion, and even tax avoidance, should be examined from the viewpoint of how much economic decisions are efficient. In this context, tax evasion is harmful to the national economy because it ensues regression in taxation, as the poor have less chance to dodge tax. Tax evasion is characteristic nevertheless of small and medium-sized enterprises, while multinationals have the opportunity to move from jurisdiction to jurisdiction. They are then able to minimise their tax burden even if they forbear from breaking the law. It is perhaps the most harmful effect of tax evasion, not to mention the loss in revenue for the state, that it is to distort economic competition. Those who comply with the tax law are discriminated while competing. Fiscal policy will also be adversely affected by tax evasion, and taxation will prove to be an imperfect tool for pursuing government aims because the anticipated conditions will not remain the same as a consequence of tax evasion (*ibid.,* 55).

The function of tax administration is to eliminate the discrepancy between what is observable and verifiable. Identifying irregularities is a key to combating tax evasion. Success in verification is in turn crucial for the tax authority in cases of tax avoidance. Tax collection can be more efficient if the tax authority avails itself of the estimation of tax liability as an alternative to relying on books, of bargaining with the taxpayer in terms of tax rulings, or of the delegation of tax collection to private contractors by letting out of outstanding tax claims (*ibid.,* 66–67). In individual cases, as suggested by the Coase theorem, bargaining with the tax authority can be a solution rather than sticking to the rigid *a priori* rules of tax administration. Bargaining is a key term of the legal phenomenology as well, discussed below.

## Methodological considerations: formalistic and material, positive and normative approaches to law

It is only one side of tax evasion and tax avoidance that they are to distort economic decisions. They also threat the intactness of the legal system. As an alternative to a formalistic approach (suggested, e.g., by the rational choice theory), in some cases the best predictions may be yielded by the assumption that individuals choose certain acts because it is the norm to do so, rather than they would base their actions on an outcome-oriented evaluation of costs and benefits (Kerkmeester 1996–2000, 385). Legal rules can be respected not simply because it is in

the best interests of people to follow them. Legal norms – as social norms – are not necessarily obeyed because of utility considerations. The non-economic motivation (prejudices, cultural traditions, etc.) of citizens' allegiance is also part of social reality.

The analysis of law may be confined to a mere positivist standpoint from which the possible subjects of a study are:

- efficiency in economic decisions;
- market equilibrium;
- the positive law as manifested in statutory laws and precedents; and
- the ways in which the means of production are appropriated (or: what should be the source of wealth?).

Furthermore, from a normative viewpoint, a study is concerned with the evaluation of the followings:

- the management of the interests of the owners' of the means of production (or: what should be the right economic conduct with a view to reconciling the considerations of the self-regulating market and the state intervention in the economy?);
- individual availability for economic entitlements and rewards (with particular regard to the profits to be appropriated in individual cases); and
- enforcement of redistributive justice (mainly through state mechanisms).

Economic and legal institutions can be studied by focusing on the polyvalence of the historical particularities in individual cases. Law is always seen in such a context as a product of history. This way of thinking leads to a material (not necessarily noumenal but always normative) approach to law. In contrast, the study of law may focus on the logic in the operation of legal institutions, irrespective of their historic connections. This approach may entail a conceptual – a formalistic – description of legal institutions, seeking to explore the functions to be filled, the structures to be developed by the legal institutions and the kind of interaction developed between a legal institution and its environment.

The material approach to law and society can be complemented not only in the direction of formalism but also by focusing on transcendental values. In the current phenomenology, a transcendental viewpoint does not arise from the classical philosophy of Kant or Husserl where the phenomenal and noumenal layers of reality are clearly distinguishable and the facts are strictly differentiated from essences. Instead, the notion of "discourse" can be introduced. It has its distant roots in what can be called the transcendental turn in the contemporary philosophy

where the analysis is addressed not to facts but to their conditions of possibility. This may also be called structuralism where the line separating from each other the "empirical" and the "transcendental" has become impure (Laclau 1993, 431). As Wittgenstein says, "language games" embrace both language and the actions in which it is woven (*ibid.,* 433).

In a positivist inquiry into the law, the positive law must be distinguished from the natural law, as law and morals must be separated from each other at the outset. A system of positive law must therefore be assessed in view of its own values and law cannot be explained by the – meta-juristic (ethical, political, etc.) – values coming from outside and above the law itself. This is an objectivist view of law, sceptical about the natural law values, albeit not necessarily identical with the approach to the legal regulation of social groups in which customs (Simmel 1970, 123), the "organic law" (Ehrlich 1970, 154) or the "fundamental accepted (primary) rules" (Hart 1958) can be highlighted. In a sociological viewpoint, law cannot be seen as valid unless it is followed. Normativity of law will thus be underestimated, compared to the realisation of law, and the concepts of the validity and the development of law will actually overlap. In this context, the legally relevant circumstances of real life are deteriorated compared to legal sources, legal sources are underestimated compared to the legal practice, and the legal practice is underrated compared to meta-juristic determinations.

The conception of commands as the core of law may suggest that the system of law could be legitimised from values coming outside and above the law itself. Law may still be developed not only in a set of hierarchical commands but also out of mutual expectations. Truly, law cannot be necessarily ascertained by invoking the coercive power of a state. A high degree of discipline, embodied normally in commands, is, however, indispensable in the development of law. It is fundamental in the conception of law that it proposes personal coercion which is one-sidedly mediated from a centralised power, albeit through values of civilisation. Herbert Hart asserts that primary legal rules provide facilities more or less elaborate for individuals to create structures of rights and duties for the conduct of life within the coercive framework of the law. During the development of a legal system, it is possible to move from primary rules to a more sophisticated system of "secondary rules", the basic elements of which are the rule of recognition (producing an authoritative mark of the legal system as such), the rule of change (suggesting the way in which authoritative laws can be replaced), and the rule of adjudication (empowering courts to make authoritative decisions) (Hart 1961).

## Obligation to obey the law

In a society, legal rules are regularly respected. It is yet a question what the reason can be for obedience. It is a question if there are *prima facie* moral and legal duties. If so, the general duty to obey the law can also be ascertained. Even if *prima facie* duties are not recognised, one can conclude that general obedience exists in a society. It may come up from the social environment, comprising rights that cannot be exercised but together with duties. Individuals, albeit with entitlements, are inherently bound in their actions to the constraints arising from the need to operate a community. The legal obligation to obey the law is derived eventually from the common good, manifested in a community under particular historic circumstances.

Alternatively, the duty to obey the law can be interpreted in accordance with a contractarian vision of social life. John Rawls argues for an obligation to obey the law from a base of consensual promises. He states that there is an implied social contract entered into by citizens who promise obedience, and by the state who provides benefits and protection to its citizens. To eliminate the arbitrariness of natural endowments of capacities, Rawls's hypothetical contract has individuals choosing general rules for their society before they receive what makes them different from one another. In the "original position", or "behind the veil of ignorance", everyone prefers the same rules because everyone is identical with everyone else. These "original" individuals, or "noumenal" subjects of law, are rational in the sense that each has "a coherent set of preferences between the options open to him". The free-riding aspect of social rules is the basis of all social contract theories that derive justification for public coercion from a putative voluntary unanimous agreement.[1]

One cannot take it for granted that civil disobedience is allowed. In a theory of law, however, where legal norms gain their authority and even integrity from higher-degree values of the morals or the natural law, it is not precluded to approve resistance against the positive law. On the contrary, in a purely analytical conception of law, where law and morals – and even positive and natural law – must be separated from each other, there is no room for civil disobedience. Law must here simply be respected as long as it is valid. In a developed legal system, however, there are still subtle channels through which valid legal rules can be changed.

Theoretically, one can suppose that the development of individual legal relationships is always preceded by a preliminary legal relationship produced by the obedience of legal norms. Such a preliminary legal relationship can be traced back to a *prima facie* duty which is inherent in the intuitions of those who follow the law (Smith 1996, 466).[2] This is an explanation of the development of legal rela-

tionships what can be called intuitionalist. It can also be considered "commonalist": namely, in the meta-ethics of William Ross, the faculty to obey the law is born in everybody. He argues that we intuitively perceive a small set of foundational *prima facie* duties which are the basis of all moral judgements. He insists that it is crucial to resolve moral conflicts by appealing to our strongest duty, irrespective of consequences.

Ross believes in the objectivity of moral values and also in someone's faculty of complying with these values, including legal rules. In addition, his explanation offered for the implementation of law is not established on catechistic meta-ethics. In his view, as opposed to Kant, morality cannot be discovered by means of rationality. On this basis, morals are not teachable (*ibid.,* 468). Hence, because commonalists assume that people have acquired somehow an inchoate knowledge of a common morality, they do not suppose that normative principles are subject to learnability constraints (*ibid.,* 471–472).

Despite the interest and subtlety of various catechistic arguments, there is scant intrinsic plausibility to the supposition that ordinary people require philosophers' aid to discover what they ought individually and collectively to do. It is an even more serious obstacle to the evolvement of the moral values to be taught that the modern (and post-modern) society is internally differentiated in a large scale, that is, it is divided into relatively independent subsystems where each subsystem is organised according to its own logic. European society has evolved into a functionally differentiated system. Each of the subsystems accentuates, for its own communicative processes, the primacy of its own function (Luhmann 1995, 30–31). In such a framework, moral thoughts cannot affect people unless they adapt themselves to the inner logic of such a subsystem.

In a purely analytical conception of law, tax evasion cannot be legitimised. No matter whether the liability to pay tax is traced back to a general obligation to obey the law that arises from the social interplay, or to a hypothetical contract under which compensation for the tax paid can be claimed. Neither is of relevance in this respect whether *prima facie* duties are recognised or the assumption of law underlies the conception of commands as the core of law. Tax evasion may be forgiven, however, in the context of natural law values. In this instance, the assumption of natural law implies the possibility that within a system legal values can be in conflict with each other which can still be solved by means of the higher-degree values. This is why breaking the tax law can exceptionally be legitimised by invoking values higher than those of the positive law. It is finally noteworthy that in the efficiency-based view of law and economics, where tax evasion is considered a wedge between reality and the legal representation, or misrepresentation, of fiscal law, the specific question does not arise at all if tax evasion might be lawful.

**Authority of law and loyalty**

The legal system in a society requires legitimation or authority, meaning that the legal rules issued have been widely accepted. In a legitimate legal system, the legislator's considerations are content-independent. Hence, in individual cases, the authority of the law is not directly connected with individual legislative considerations. Also, it is important for the claim of the authority of a legal system that authoritative utterances are advanced exclusionary (Wellman 1996, 575). Normally, authoritative utterances are understood as reasons which exclude other reasons for the agent's acting (*ibid.,* 577). It is of material importance to the authority of law whether there is an inherent logic in the legal system. The authority of a legal system does not depend on, however, whether it is welcomed by those who follow the law. It is in this sense not absolute (*ibid.,* 578).

The authority of law results in the release and the enforcement of legal rules. It does not imply the obedience of the law, however. The term of the authority of law concerns the issuance of values (this is an output effect) rather than a mechanism of recognition (that would be, in turn, an input effect) (*ibid.,* 579–580). The obedience of law assumes the cooperation of those who follow the law with the legislative power. Obedience accentuates the micro aspect of law, that is, the individual historic circumstances under which law is honoured, while authority concerns the macro level of a legal system, corresponding to the mechanisms of the creation and legitimation of law.

Like the obedience of law, loyalty is also imbedded in a particular historic context. While the search for truth denotes a motion towards the universal, that is, towards what is common, although hidden, in people, loyalty, bound to specific circumstances, is partial. This partiality is in discrepancy with the search for truth which would require objectivity.[3] Loyalty and the aspirations for objectivity in various actions – partiality and impartiality – may nevertheless complement each other. Liberals do not sympathise with loyalty in which they see constraints for individual decisions, although nobody can disagree with the statement that the freedom of conscience cannot be exercised without regard to the rights, or legitimate interests, of the other. In a communitarian viewpoint, personal interdependencies are emphasised. Consequently, loyalty will be well accepted, too (Fletcher 1996, 527–528).

By our time, fiduciary relations have been proliferated. This is because the major traditional social institutions (ownership rights, employment contracts, etc.) have all the more been covered by personal interrelationships. Sporadic bargaining can substitute for the *a priori* structures of formal rights. The rapid development of financial markets cannot dispense with the vide variety of fiduciary accounts. Fiduciary relations are in particular apt to bridge over the gaps arising

from the asymmetric political structures of a society. For example, proxies may act on behalf of their principals who are not provided in a particular historic situation with full citizenship, or who are reluctant to disclose their identity before the public. It is, however, the disadvantage of fiduciary transactions that the division of the ownership rights among several persons, or groups of persons, may deteriorate transparency of economic relations. Abundance in social roles may also entail the abuse of law (including tax avoidance). As a consequence, loyalty may be enforced to the detriment of such institutions as legality, allegiance, or the integrity of professions.

Business schemes covered by fiduciary duties can also be problematic for tax purposes. The first question is of how taxable income can be divided between legal and beneficial owners. Both double taxation or double non-taxation can occur, depending on the special circumstances. Loyalty is also associated with the problem of related parties that raises the accounting, and fiscal, law problem of transfer pricing.

## Law observed in a holistic view: coherence of law

A theory can be said coherent first of all because of its monism and unity. It must thus rely on principles consistent with each other and its precepts must flow from these principles (Kress 1996, 532–533). A coherence theory is an alternative to a traditional theory of truth, called correspondence theory. According to the latter, the theory's propositions are consistent with the facts of the real world, independent of the theory. It rests on the optimistic view that there are things, independent of us, and there are substances in things that can be rationally explored. A correspondence theory conjures the picture of linear justification from basic beliefs. By contrast, a coherent theory of truth suggest a spider's web (*ibid.,* 535).

Unlike the macro perspective of a theory of correspondence, a theory of coherence is to reflect the world in a micro perspective. The physics of society, different from the phenomenology of society, concerns social groups and their relations (in particular, their conflicts) or the mechanisms of power. Instead, a phenomenological view concerns the social practices where mutual expectations and discourses can be developed in small groups. Habermas insists that, in late capitalism, administrative planning has unintentional effects of disquieting and publicising. These effects weaken the justification potential of traditions: "Once they are no longer indisputable, their demands for validity can be stabilized only by way of discourse. Thus, the forcible shift of things that have been culturally taken for granted further politicizes areas of life that previously could be assigned to the private domain" (Habermas 1995).[4]

In a macro perspective of the social world, the objective relations of social structures are produced during the distribution, and redistribution, of resources in the competition of capital and scarce goods. As Bourdieu argues, agents are distributed in the social space according to the overall volume of (economic, cultural, social and symbolic) capital. In a micro perspective of a society, these agents are arranged according to the structure of their capital, that is, to the relative weight of the different species of capital. In the micro segment of social space, the macro-related distribution of goods can be authenticated by people who are able to realise their *hic et nunc* personal positions, readjusted to new circumstances, as the case arises. A particular sense of one's place may lead people in interactions to keep their distance or to maintain their rank (Bourdieu 1995, 325–326).[5]

The coherence methodology used in modern normative theories is plainly expressed by the technique of the so-called reflective equilibrium with Rawls, who requires that judgements about normative issues should be made by individuals with average intelligence in idealised circumstances which promote integrity, impartiality and insight (Rawls 1957; for further explanation: Kress 1996, 535). So the coherence of law cannot be achieved unless reflective equilibrium is achieved. Reflective equilibrium is a state of law developed by those who comply with the law in a particular case. Coherence does not mean simply that the legal norms applicable to a particular case are consistent with each other. It is also necessary that there is a number of addressees who realise the law and attain harmony in their actions with legal norms and, accordingly, with their social environment.

Dworkin asserts that a proposition is law if it follows from the morally most appealing set of principles that meet or exceed a threshold of fit with legal institutional facts (constitutions, statutes, precedents) (Kress *op. cit.,* 546). He assumes that the citizens' political obligations include obligations laid down in explicit rules of law. However, he claims that citizens' obligations must not be thought of as exhausted by the explicit rules. Rights can flow from the values of equal concern for the other members of the political community that underlie the explicit rules. Citizens can infer such inexplicit obligations and rights from the values underlying the explicit only if the explicit rules are coherent (see the explanation of Kress *op. cit.,* 550).

In the field of law, the issue and enforcement of legal rules is a matter of macro-level happenings. They are to be complemented by important issues – appearing as the micro aspect of law – like those of bargaining of private persons with public authorities or the private constitutions drafted by large corporations through the network of comprehensive contracts. Kress asserts that in the coherence theory, "law is a seamless web … it is holistic, … precedents have a gravitational force throughout the law ..." (*ibid.,* 536). Presumably, the abuse of law is also a problem of the law that can be studied best from a holistic point of view.

**Use and abuse of law, bargaining and advance rulings**

The common physics of law does not say much about how people strive to solve their specific problems, whether by legal or non-legal means. It is not possible to elaborate guidelines for them but on a very high level of abstraction, far from everyday reality. This is because the legally relevant situations are flexible and constitute ever-changing structures. One can fear that very practical problems cannot be solved by simply invoking legal principles which are otherwise widely accepted (the prohibition of the abuse of law, true and fair view principle, etc.). In a legal system, where conflicting legal rules emerge, the *lex specialis* should prevail over the *lex generalis* in order to re-arrange the order of legal rules. This is a sound practice by means of which the scope of the application of highly abstract principles is limited. In other words, a legal system cannot bear without limits the "constitutionalisation" of law where specific legal problems are directly referred to one or more of high-level principles, and the legal determination of the case merely rests on the application of these principles.

From the angle of the phenomenology of law, exercising rights is not content-independent. On the contrary, it can only be clarified in a particular case, depending on the clarification of the circumstances, whether rights have been exercised properly or abusively. It is typically a question of coherence to adjudge if the use of individual rights is in compliance with the proper functioning of the law. In this respect reference cannot be made to the great mechanisms like social classes or the concentration of the power of redistribution. It would therefore be a mistake for the legislator to assume an easy case of deciding in specific cases in advance whether individual rights are exercised properly, even if the legislation is correct in drafting the underlying hypothetical law. It is not sufficient to examine if individual actions under examination comply with the basic assumptions of a legal system. Unfortunately, it is inevitable to make such a test from case to case. This way, the conformity of individual actions with the law, and the coherence of law, need to be re-examined.

Despite the assumption of a common static view of law, the actual meaning of legal norms may be instable, that is, changing, depending on a particular case. This is because different elements of the sets of legal norms may be called forth, depending on the circumstances. Coping with the vulnerability of such norms requires a kind of relational way of thinking. A correspondence theory is operational, provided that the facts relevant to legal decisions do not change in an abrupt, comprehensive manner. In the instance where there is no longer stability in the relevant meaning of legal institutions, harmony cannot be achieved between the legal norms and the ever-changing outward reality. Harmony can, however, be reached in another respect, suggested precisely by a coherence theory. Legal insti-

tutions may produce harmony in discrete micro relations where the applicable norms are coherent and the people involved in them have developed their sense of communication adequate to the particular case.

Filing for an advance ruling of the tax authority is therefore seen in the physics of law with suspicion. Critics may put forward several reasons to argue against advance rulings or other alternative forms of dispute settling. First, a ruling may result in privileges. This is to hurt the principle of equality before the law. Secondly, a public authority is expected to be impartial which, of course, is not possible while bargaining. With regard to these considerations, it is important in a jurisdiction to set constitutional constraints on the possible subject and form of bargaining. For example, a local government may be prevented from promising certain future tax rules in a bargain. Bargaining – as a matter of contracting – should this way be restricted for constitutional purposes. This also means that – beyond a certain border – public authority, and public law, should prevail over contracts, and thus over private law. Finally, by releasing advance rulings, the principle of legal certainty will inadvertently be hurt. As it is not possible to predict the outcome of a ruling, the law is losing from its transparency.

As discussed, the macro relations developed during the distribution and redistribution of capital and goods can be complemented by the micro relations of bargaining, in which people are involved while reconstructing the means of communication guiding for their behaviour and complying with the coherent system of norms. Taxation plays an important role in the operation of a power mechanism concentrating the social production and the redistribution of the value added of a society in a certain period of time. In connection with the second preliminary condition (offices and positions must be open and flexible) of the second principle of justice of Rawls (the difference principle or the so-called maximin criterion),[6] social justice may be manifested as a peculiar mechanism of correcting the inequalities developed during the distribution of capital and goods. This mechanism of correction may be animated in a country by the fiscal policy, making not only allocation of rewards but also following the goals of economic stability and redistributive justice.

It is not precluded in a market economy that the redistribution of goods and taxation can be replaced by alternative mechanisms. In particular, the fiscal policy with its rigid armoury can be replaced by the application of the benefit principle (public services must be paid by those who benefit from them). In exceptional cases, where *a priori* rules cease to be operative, the situation can be explained in the best way by the Coase theorem: the management will not be affected by how the law assigns the right to use the property but by the bargain aimed at the maximisation of the mutual profits of parties. However, Coase's device may not work for various cases, such as those in which bargaining of large groups is hard or no

market value is at stake. Notably, the scope of the economic analysis of law is limited at the outset because, while focusing on utilities, it leaves morals eventually out of consideration.[7] To conclude, although taxation as the manifestation of a correction mechanism is to be complemented by coherence-related bargaining, taxation continues to be an indispensable means of social reproduction to the extent that market mechanisms are in various respects certainly constrained.

## Validity of law and right law

Tax avoidance – or rather the abuse of law – occurs where law is circumvented, although not plainly broken. No abuse of law can be discovered where individual actions comply not only with the letter, but also with the spirit of the law. The extension of the study of law to its essence leads us to raising the question of natural and positive law as well. In this broad context, it becomes apparent that the positive-law institutions are inadvertently complemented by the morally-filtered fundamental values gained from the natural law. The more thorough study of law also raises the issue of the validity of law, that is, the question that legal norms should categorically exclude ambiguities in a legal system. The notion of the validity of law can be better understood if discussed connected with the concepts of legal ideals, technical jurisprudence and right law. The validity of law – or the right law that can be ascertained in a legal system – is adequate to what was discussed above in a micro perspective as the coherence of law.

### *Validity of law, positive and natural law*

The question is raised already by Thomas Aquinas whether it is allowed in a specific case to depart from the letters of law in order to continue to honour the spirit of law. He gives an answer to this question in the affirmative (*Summa Theologica* I–II, 96,6). To begin with, Augustine says as follows (*De Vera Relig.* 31): "Although men judge about temporal laws when they make them, yet when once they are made they must pass judgement not on them, but according to them." Also, *Proverbs* may be quoted (8,15) in the similar sense: "By Me kings reign, and lawgivers decree just things." Hence, judges are stricty subject to legal prescriptions. However, Hilarius says as follows (*De Trin.* iv): "The meaning of what is said is according to the motive for saying it: because things are not subject to speech, but speech to things." Thus the genuine meaning of law cannot be based but on the knowledge about the motives of lawmakers. Similarly, the Roman law teaches [Pandect. Justin. lib. i, ff., tit. 3, *De Leg. et Senat.*] that "By no reason of law, or fa-

vour of equity, is it allowable for us to interpret harshly, and render burdensome, those useful measures which have been enacted for the welfare of man."

It seems to be appropriate to examine the problem of the conflict between the spirit and the letter of law in the context of the relationship between natural and positive law. Hence, the concept of law is of double nature. Namely, it prescribes, on the one hand, natural patterns of behaviour, that is, patterns of behaviour of universal validity to be followed in all societies and drafted as a preliminary condition for social co-operation. On the other hand, law reflects positive, because politically organised, historically determined interests. During long centuries, natural manifestation of law was nevertheless seen as predominant. The one-sided respect of positive law has only come at the turn of the 19th and the 20th centuries. Even Marxism that has always stressed law being subject to the interests of social classes is based on the ideas of natural law. This is because, measuring law on the scale of historic progress, Marxists subject law to the realisation of social justice and anticipate that law will inadvertently wither away in a historical process. The fact that the natural values of law are more conspicuous than its positive features should be taken for granted since, as opposed to the clash of society into individual interests, the consideration of personal integrity, and moral responsibility associated with it is, or should be, fundamental in all human behaviour.

Law, broadly speaking, extended in its scope beyond statutory law, is to be interpreted in the duality of lawfulness and factualness. Normativity and factualness are to be discerned in relation to the Kantian concepts of "Sollen" (Ought) and "Sein" (Is), or validity (Geltung) and effectiveness (Wirksamkeit). During the process of implementing norms, normativity turns into facts and facts imply, in turn, patterns of behaviour with a potential for creating norms (Kelsen 1928, 96). Normativity and factualness, turning into each other, can be paralleled with law-making and the implementation of law, interrelated to each other. This interplay can be depicted in a structure of distinct degrees, associated with particular legal sources. In view of Hans Kelsen, the system of legal sources, located according to distinct degrees, begins with the so-called hypothetical basic norm (hypothetische Grundnorm). Then the degrees of international law and constitutional law, after then laws and regulations or decrees may be ascertained. Finally, individual decisions made during the administration of law may be identified to also imply normativity. In the process in which law will be more and more specific, the distinction that can be made between law-making and the implementation of law will be relative: A legal norm occupying a certain degree in the hierarchy of legal sources obtains its validity from the legal norm located next to it at a higher degree. In this sense, making the second legal norm is the implementation of the first one. Simultaneously, the second legal norm itself also implies the po-

tential of the implementation of law for a legal norm located in the hierarchy of legal norms in a lower degree, relative to it.

The validity of legal order cannot be traced back to the mere facts of individual wills, actions, decisions or deliberations made in the administration of law, or to resolutions of law-making bodies. This is because these facts only suffice to fill the contents of the legal order in a country. Legal validity can – in Kelsen's understanding of law – be ascribed to the hypothesis that the basic norm is the final source of law. For purposes of law-making, the basic norm is the legal norm of highest rank in the hierarchy of legal norms that cannot be justified but in a transcendent way, and cannot be identified but to the final authority of law. While established on transcendent values, it is able to gain invention from customary law as well (*ibid.,* 93–94).[8] The basic norm of Kelsen has, of course, nothing to do with every-day reality. This is because its validity is only of hypothetical nature. It is only able to become specific as manifested in individual legal provisions. The basic norm is nothing but a force of regulation or a basic idea that presupposes and anticipates law-making. Law-making that does not reflect the basic norm relevant to an individual situation correctly is flaw. The same is true for the implementation of law, not in accordance with the basic norm revealed in a specific case. Complying with the letter of law, parties may well miss right law in the instance that they do not comply with the basic norm hidden in specific conditions.

Had Hobbes been right in claiming that "auctoritas, non veritas facit legem", a legal system is of no need to be legitimised from outside. It is thus not necessary to rely on a hypothetical basic norm suggested by Kelsen. It seems to be sufficient to explain the valid law from itself where the legal tradition relevant to particular historical circumstances may substitute for the transcendental values generated from hypothetical norms. The legal tradition of a country may imply the potential to present guidelines even for the constitutional practice. This tradition can be placed simultaneously at the bottom and the top of the legal system where it represents both the essence of the legal practice evolved under the umbrella of statutory law provisions, and the highest-level assumptions upon which a valid legal system rests. The validity of a legal system is in this context reproduced due to the inner forces of the law itself.

To the extent that this concept of valid law is self-generating, it is the product of a purely analytical view of law, separated from moral considerations or the values of natural law. Unlike the coherence of law, it remains still a macro category of law that concerns the legal system as a whole and is independent of the need for subjectivist methods aimed at reconstructing the ways of communication relevant to particular situations. It is a category of the monological new-Kantian philosophy, different from the recent phenomenology, according to which moral values are derived from inter-subjective ways of communication. The new-Kantian con-

cept of validity is nevertheless similar to current phenomenological views, requiring the relational way of thinking in the instance that the validity of certain legal norms is determined in relation to the legal norms proximate to the former ones in a close-circuit system.

*Legal ideas, technical jurisprudence, right law, equity*

For purposes of identifying the meaning of right law revealed in individual positive law provisions, it is necessary first to unveil the "legal idea" (Rechtsgedanke) as related to a certain legal institution. In comparison to legal concepts (for example, capacity to conclude contracts, enforcement of rights by way of bringing legal actions before courts, etc.), legal ideas (for example, freedom to provide services or the protection of rights as guaranteed by a state) represent forms of universal validity. Although legal concepts may be authoritative to specific cases to the extent that they affect the material to be perceived in specific conditions, they themselves are subject to further determination, in contrast to legal ideas, predominant in legally relevant arrangements (Stammler 1926, 14–16). In a legal context, something that is "ideal" relates to a grouping of the constituents of a legal idea as a benchmark that can be approached, although not reached, by individual actions. Eventually, a legal idea is aimed at the unity in human efforts and can only be explained by conceptions. It implies the harmony to be disclosed in human actions (*ibid.,* 17–18).

With a view to better understanding right law, the "technical" and "theoretical", or pure, jurisprudence can also be discussed. Technique is manifested in tasks developed in cognition that not yet reaches the final validity of the knowledge about a subject. As such, technical cognition concerns only limited targets. Technically-minded cognition is not necessarily directed to a unity in concepts. Instead, it addresses a system of thoughts that is directly affected by material developments. In comparison to technique, theory is the degree of knowledge at which it is possible to grasp the totality of the subject to be studied (*ibid.,* 39–40). In Stammler's view, both technical and theoretical jurisprudence is based on the methodology of cognitive criticism relying on the analysis of objectively perceivable reality (*ibid.,* 34).[9]

"Right law" (richtiges Recht) is the law that reflects the legal idea emerging from positive law. Right law is the same as positive law to the extent that, in particular terms of claiming, affirmation or negation, it can be traced back in various cases to a legally relevant, individual will that implies the basic idea envisaging unity in the contemplation of reality.[10] In assuming law and order, each maxim of law potentially implies right law and, in accordance with the intrinsic nature of

positive law, it is inclined to become right law (*ibid.,* 56–57).[11] Even though right law, and the ideal in law, can at any time be developed in principle, one has to acknowledge that, in contrast to religious belief or the morals, law cannot be considered as a final goal in life or as an instrument of spiritual guidance (as Terentius says: summum ius summa iniuria) (*ibid.,* 58–59).

Based on "equity" (Gelindigkeit), rather than right law, decisions can be taken that are of no universal validity. However, those who follow law may be guided by particular considerations, by way of which it will be possible to arrive at right decisions in accordance with social ideals. Equity (επιεικεια), as a particular consideration of decisions, in contrast to a *stricti iuris* solution (δικαιοσυνη), contains the possibility of correction in individual legal cases (in this respect, it resembles what is called in English law as equity). In tax administration, equity can be of particular importance, for instance, in the practice of revenue authorities that exercise discretion in certain matters. Equity does not imply ideas that generate forms. However, due to its application, it is easier for decision-makers to elect right rules relevant to specific cases. Equity is embedded in the material of historically determined positive law, while encouraging the administrators of law to seek for right law (*ibid.,* 174–175).

### *Examples for the true interpretation of law*

In consideration of the gradual structure of a legal system, national laws are valid to the extent that they implement the international law, based on the idea of Grotius on the topic (according to it, simply speaking, international law is the law of peace).[13] In the light of the unity of national and international law, the principle of *pacta sunt servanda* is of universal validity. Thus, among other things, it also relates to interstate contracts to be implemented in good faith. As a classical example for the conflict between the letter and the spirit of law for the purposes of the true interpretation of law, it is interesting to note the peace treaty of 240 BC, which was concluded between Rome and Carthage, and which provided that contracting parties were prevented from entering into separate agreements with their allies and with the states subject to them. As is common knowledge, in 227 Rome decided to conclude a treaty of alliance with Saguntum. Then, the question arises as to whether Carthage broke the pact with Rome at the time when Hannibal attacked Saguntum, among other things for the reason that the Saguntians had entered into a separate agreement with the Romans. The answer depends on how the pact made between Rome and Carthage is to be interpreted. Undoubtedly, according to the wording of the pact, it is only prohibited to enter into separate agreements in respect of the states, allied or subject to Rome or Carthage, respectively, enumerated

in the pact. According to the spirit of the pact, it is designed in fact to prohibit parties from entering into separate agreements in the same way with those who have become states allied or subject to Rome or Carthage, respectively, since the conclusion of the peace treaty, as with those who were already known to parties at the time when the peace treaty was concluded, and so who were duly indicated in the agreement.[14]

In current international tax law practice, there is still not much chance, for instance, to enforce the so-called "große Auskunftsklausel" efficiently. In principle, being bound to each other by a double tax convention, national tax authorities with competence are, under most double tax conventions, obliged to exchange information not only regarding the implementation of the treaty itself, but also concerning the implementation of domestic law in respect of national tax rules related to the treaty to be applied. In fact, there is usually only a forlorn hope in most cases that the competent tax authority of one country has recourse to the legal machinery of the other country and, as a consequence, the second country is ready to assist the first country in enforcing the tax claims developed in the first country. The question here is about the possible waiver of at least part of the sovereignty of nation-states, traditionally preserved in an international legal order, consisting of separate nation-states. In regard to the rapid development of international trade, a claim that can be raised in relation to the application of "große Auskunftsklausel", or of other legal means of administrative cooperation in fiscal matters, even multilaterally, does no longer seem to be an exaggeration. Remarkably, the OECD model treaty as quoted above prescribes the broad language text that affords tax authorities more elbow-room [Article 26 (1)].[15]

More broadly, it is a question whether, for example, the violation of banking rules abroad may be sanctioned in a country in a civil-law, or criminal-law context despite the fact that there is no violation of effective national laws. Even if civil-law nullity may be declared, it is dubious enough to seek for prosecution under criminal law (it is a preliminary condition for the qualification of individual actions as a crime under the criminal-law concept of crimes that effective unilateral laws, or treaties in force, must have been explicitly violated). This strict interpretation of irregularities may well be necessary in the traditional perspective of the rule of law principle. However, it is an obstacle to the enforcement of right law that, for the lack of international agreements that are exact enough, such a point of view impedes combating undesirable phenomena such as money laundering or international bribery. The internationalisation of commerce, and the globalisation of financial markets, will most likely enforce that the creative, more relaxed approach to the administration of law should prevail over the implementation of law remaining within the boundaries of an isolated nation-state. This is because it is all

the less possible to cover legal areas by traditional nation-state instruments. In critical points, the reference to right law may then be crucial.

## Economic valuation and financial information

Exploring the integrity, and the real meaning, of the legal norms applicable to allegedly abusive schemes is not plausible unless the information relevant to critical cases is available. In the rational choice theory, it is supposed that the values under discussion are commensurable with each other. For the purpose of interpreting tax avoidance or, broadly, the abuse of law, it is of significance that the relevance and certainty of economic valuation and financial information has been doubtful during the proliferated processes of the separation of ownership and control, and the discrepancy between legal and economic identity. Prudential management, the protection of equity and the equity-method-based assessment of the assets concentrated by certain companies in certain segments of markets are issues of direct relevance not only to company or accounting law, but also to the calculation of tax liability.[16]

### *Relevance* versus *certainty of information, true* versus *fair information, normal and natural prices,* ex ante *and* ex post *governance*

Safeguarding of the equity of corporations is important in all countries. Particular emphasis is placed, however, on it in countries like in Hungary, the financial and tax system of which are modelled on German patterns. In such countries, the socio-economic environment demands from accountants not only to provide information for the only interest group of shareholders. Annual accounts are addressed more widely, that is, to various groups, including, e.g., creditors, minority shareholders and the treasury. In this context, the preservation of capital – closely connected with the principle of conservative accounting – is regulated in a comprehensive way (Baetge et al. 1995, 92).

The protection of capital in company law, accounting and taxation is not simply a matter of complying with legal provisions literally. It is even more important to honour the procedures of sound and prudent business management. In regarding the spirit of laws, it is a key to effectuate the true and fair view ("TFV") principle, according to which, in order to give a true and fair view of the company's financial position in a financial year, directors are allowed, or rather expected, to depart from particular financial law and accounting rules if necessary. As the TFV principle anticipates the conflict between the letter and the spirit of law, the poten-

tial overriding status of it has become apparent. In the recent decades, the accounting practices, including the rise of the TFV principle, have been considerably dependent on the social and economic environment. Accounting cannot be considered longer merely as a system of measuring financial values. Objectivity does not seem to be sufficient longer. In the context of esoteric financial transactions, assets cannot be evaluated separately. Instead, the so-called equity method is applied to assess the benefit that can be derived by the management of a set of assets in a market segment. This is what Oliver Williamson called asset-specificity.[17] The certainty of financial information has become more important for the users of accounts than the simple relevance of that information. Lessons can be taken in the current economy from the fact that information which may well be true is not necessarily fair. For example, windfall gains (e.g., income generated from the compensation of damages) have the same cash effect as other income. Their relevance to the future cash generation ability is, however, less significant.

The classical value doctrine is based on the assumption that people's economic conduct is eventually motivated by seeking for profit. This view is without regard to whether economic growth is to support social cohesion. In contrast to mercantilist optimism, the physiocrats are sceptical about the potential of economic growth to the extent that the generation of economic sources is constrained not only by the stock of gold held (monetary value) but also by the capacities coming from the ecological (and social) environment. Price formation is in this perspective not simply the result of the calculation in terms of bare exchange ratios. Normal prices should be complemented prices that can be enhanced as natural prices, being beyond the simple instrumental rationality and wealth maximisation.

In the era of large corporations, it is of particular interest to know why do we need companies. Theories of the firm may roughly be classified into two categories:

- Principal–agent models allow agents to write elaborate contracts characterised by *ex ante* incentive alignment under the constraints imposed by the presence of asymmetric information.
- Incomplete contracting models are founded on the assumption that it is costly to write elaborate contracts, and that there is therefore a need for *ex post* governance (Foss et al. 1996–2000, 634).

Among the *ex post* explanations for the legitimacy of firms, the implicit contract theory suggests that, in the current typical inter-company relationships, non-traditional forms of legal regulation like codes of conduct or implicit contracts have been proliferated. The development of these institutions can apparently be traced back to the micro aspects of the social space where the relational

way of thinking, communicative rationality and the discourse ethics become conspicuous: "When it is difficult to write complete state-contingent contracts, for example, when certain variables are either ex-ante unspecifiable or ex-post unverifiable, people often rely on 'unwritten codes of conduct', that is, on implicit contracts. These may be self-enforcing, in the sense that each party lives up to the other party's (reasonable) expectations from a fear of retaliation and breakdown of cooperation. The basic idea in the implicit-contract theory of the firm is that implicit contracts may function differently within firms than between firms" (*ibid.,* 642).

Another *ex post* explanation of firms considers companies as the framework for communicational networks: "… writers view the firm as a communication network that is designed to minimize both the cost of processing new information and the costs of communicating this information among agents. Communication is costly because it takes time for agents to absorb new information sent by others, but time consumption may be reduced by specializing in the processing of particular types of information. … When the benefits to specializing outweigh the costs of communication, teams (firm-like organizations) arise" (*ibid.,* 643).

### *The anti-peponthic view of money*

In the era of the institutional separation of ownership rights and the control over ownership, the instrumental rationality and cost efficiency in legal regulation has been doubtful. In terms of the concentration of capital and disintegration of ownership in large corporations, social and economic values have been changing and social consensus has been context-dependent. It has been necessary to look behind observable exchange ratios and for new realities of economy (Ekholm – Troberg 1998, 113). Such a way of thinking can be supported by Aristotle who examined the commodity-based economy in terms of corrective rather than distributive justice, focusing on exchange values. He stressed, however, that the use of money even in a market economy is presupposed by social prejudices. The mere expression of quantities is subject to adjustment, arising from non-economic assessments. The quantitatively interpreted equality has been corrected this way by the introduction of the concept of reciprocity in the economic measurement. It is true that particular goods cannot be compared to each other unless the goods, equivalent to each other, can be expressed in monetary terms. Money, derived from social concensus, cannot, however, function as a universal standard unless it produces a standard of comparison, adjusted by reciprocity. This is the so-called anti-peponthic view of money, introduced by Aristotle. To this extent, money is of nomismatic nature [see his Nikomakhian Ethics (5.8)].

In the time when there are clear normative elements that cannot fulfil the criteria corresponding to the inner logic of the market equilibrium, particular financial values can be discerned without major difficulties. In circumstances, however, where the legal identity, different from economic identity, has been blurred and the distinction between legal and economic ownership has been doubtful, it is typical that the economic values have been all the more monetised. A clear example for this is asset securitisation, a process in which a company's assets will be monetised through the provision of secured financing, that is, in terms of structured financing transactions in which securities are issued representing the right to be paid from a discrete asset pool (used as a collateral for the securities issued). It is not only problematic that monetary and non-monetary values are intermingled in such structures. It is even more serious that it is all the harder to distinct particular rights to the extent that assets will be re-structured in pools, the valuation of which is dependent not only on how the underlying assets are assessed, but also on the new financial position produced by the pool of assets. In broad terms, the boundaries of form and substance will be teased.

It is another question whether lending is based on the conclusive severance from the originator's assets. In other words: it is not clear whether two separate transactions, that is, the transfer of receivables in exchange for cash and the borrowing secured by the assets taken over and re-structured in pools, are to be accounted for. As an alternative, looking through the intermediary, the originator's financial position will not be remote from the investors' claims. The suspicion that a series of disguised transactions has been concocted can be especially lively in a scheme where an investor's claim can be secured by the receivables originated by his or her own bank from his or her own liabilities. On the surface, a particular claim cannot, of course, be corresponding to a particular debt. The economic contents of the scheme as a whole may, however, suggest this conclusion. The universality of financial claims is further deteriorated by trenching. This way, payment streams are hierarchically arranged in priority of payment. Due to the blurring borderline between particular transactions, the accountant has to face the problem of how to disentangle in-balance sheet and off-balance sheet items. For the lawyer, the main problem is how to identify contractual rights and obligations in a case where a degree of control over the transferred assets has been retained. Contractual rights and obligations will be complemented with fiduciary rights and obligations, amending the legal meaning of the underlying business. The execution of contractual rights will then be constrained by fiduciary duties, equitable in nature (Ellis 1999, 295).

## 2. REGULATORY ISSUES

Tax evasion taken by itself does not seem to be a problem of legal interpretation, not to mention the distinct question of breaking the obligation to obey the (tax) law. Some regulatory issues arise, however. Non-compliance clearly entails the liability of taxpayers to pay late payment interest and penalties, as required by the law (not covered by this paper). It is another problem that, in the recent years of judiciary practice, the borderline between tax avoidance and tax evasion has been blurred. The criminalisation of tax avoidance will therefore be examined. Tax evasion is to be discussed in close connection with the shadow economy, in particular with bribery. The most important fiscal law implications for bribery will be set forth. The legal regulation of disclosure requirements, data management and fiscal secrecy are obviously relevant to anti-fraud measures, which will also be examined in brief. The questions of presumptive taxation and advance ruling – discussed above in a theoretical perspective – represent alternatives to the traditional approach to tax collection. They will also be dealt with, now from the perspective of legislative policy options.

It is reasonable to make inquiries about regulatory issues, based on the description of how taxpayer rights (and liabilities) are structured in a valid legal system. In the context of being legally subjected to norms and in that of enjoying constitutional rights and fundamental freedoms, the use or abuse of taxpayer rights can be interpreted not only relating to tax avoidance but also to the proper exercise of the public authority in the field of tax collection. The contradiction between the letter and the spirit of the law – discussed above from a theoretical point of view in connection with the validity of law and the right law – will be highlighted below with regard to the possible regulatory considerations of tax avoidance. As a matter of legal regulation, the conflicts between the legal form and the legal substance on the one hand, and the legal form and the economic substance on the other hand, can be enhanced in this respect.

### Criminalising tax evasion

Tax evasion and tax avoidance concern more than simply the problem of losing public revenues. It is even more important whether business transactions can be kept transparent enough. From such a perspective, it is of particular interest that the circumvention of tax laws can be criminalised and that the basis for prosecution can be not only the explicit reference to the infringement of the particular provisions of fiscal liability, but it is also possible to rely on the allegation of non-fiscal crimes, still related to fiscal matters.

For a long time it has been widely accepted by professionals that it is no problem to distinguish between tax avoidance and tax evasion to a certain extent. Although in both cases public revenues will be curtailed, in the first case no letter of law will be broken even if the law in question will be circumvented, while in the latter case particular law provisions are explicitly infringed. An outstanding example taken from the international practice for that tax avoidance can be criminalised is the British case of Charlton.[18] In that case, the question was about simple schemes of tax avoidance. Remarkably, the unpaid tax basically derived from the insertion of a Jersey company, that attracted some profits, was later duly paid with interest. However, the Inland Revenue prosecuted tax advisors by alleging both *actus reus* and *mens rea* and insisting on that the Revenue had eventually been cheated.

Although in Hungary there is no broad basis for alleging tax fraud like the common-law concept of cheat in Britain, the crime of fraud can be relevant to tax matters in Hungary as well. The main difference between the crime of tax fraud (Section 310 of Criminal Code) and fraud (Section 318 of Criminal Code) is that in the former case the cheating of the Treasury is connected with the infringement of the provisions on fiscal liability, while in the latter case, in alleging the crime, there is no need to prove whether provisions on fiscal liability have been infringed. In a legal case in Hungary, the court stated that in the instance when the unjustified claim of the recovery of VAT is not connected with the taxpayer's turnover, the question of fiscal liability cannot be raised, albeit the crime of common fraud relating to the restriction on public revenues may still be alleged.[19] Needless to say, it is easier to simply criminalise fraud than tax fraud insofar that, in the latter case, the Revenue need not get involved in interpreting convoluted tax law provisions, because it is not at stake whether the rules on tax liability have been infringed. The narrow scope of alleging the crime of tax fraud can this way be broadened with the consequence that the common cheating of the Revenue will be more vulnerable.

The main lesson of the quoted Charlton case is perhaps that the prosecution is not precluded even in the absence of the unpaid tax claimed. The crime of fraud (Section 318 of Hungarian Criminal Code) is material to the extent that the cause of damages must be demonstrated, although fiscal liability is not necessarily covered. In respect of false accounting (Section 289 of Hungarian Criminal Code), it is not required even to prove damages caused. Instead, it suffices to say that the accounting discipline has been infringed, irrespective of whether it has resulted in damages. In addition to the crime of false accounting, money laundering (Section 303 of Hungarian Criminal Code) can also be associated with tax evasion. Again, no matter whether unpaid tax is claimed. The crime of money laundering can widely be prosecuted. Money laundering actually appears in the context of the Hungarian criminal law as a particular form of the crime of receiving stolen goods

(Section 326 of Criminal Code). This latter crime concerns someone who acts in bad faith while involved in the deal in goods of unclear origin or in a suspicious transaction. The particular feature of money laundering different from the receiving of stolen goods is that money laundering is associated with money transfer through a bank. The prosecution of money laundering is a distinguished task the European governments have recently undertaken.[20]

To date, there have been all the more signs of concerted efforts to combat fiscal fraud and eliminate harmful tax competition in the international arena. Criminal-law initiatives have been renewed as well, not to mention the conventional civil or fiscal law instruments to combat non-compliance with fiscal law, whether fiscal evasion or tax avoidance has been committed. In addition to the protection of the tax base, it has been even more important for various government agencies to be successful in enforcing transparency in commercial transactions as well as compliance with the sound and prudent business management.

## Tax evasion and bribery

Bribery means corruption, that is, an attack against the public good, public interest or public order. Bribery corrupts official duties. While international business has been globalised, bribery has also been proliferated. The size of corruption depends, of course, on traditions and cultural patterns. For instance, clearly, in the Northern part of Europe corruption is less accepted (although it is growing in size). It comes from the inherent nature of bribery that is not disclosed to the public, so it is not easy to get information of it. However, the research of it has got into the centre of public interest in recent years. There are research projects sponsored by public bodies as well as private institutions, including internationally recognised organisations like Transparency International that have distributed knowledge about bribery.

Hungary is member of the OECD and is a country associate with the EU. Given these international commitments of the country, the legal documents, which have been developed in the international arena with regard to the untaxed economy and bribery at the levels of the OECD and the EU, are of special importance. These documents can be enumerated as follows:

– OECD measures designed to combat bribery in the international trade;[21] and
– EU measures aiming at the misuse of Community resources.[22]

In the field of the legal regulation on bribery, the anti-avoidance measures of fiscal law are of special significance. Based on the OECD documents on bribery, a

wide scope of prohibitory provisions can be highlighted. They may be extended to the following:

– establishing off-the-books accounts;
– making off-the-books or inadequately identified transactions;
– recording non-existent expenditures;
– making entries of liabilities with incorrect identification of their object; or
– tax deduction of the expenses related to bribes.

In Hungary, by virtue of the Accounting Act, all forms of corruption and bribery are prohibited, based on the accounting principles of objectivity and the substance over form [Sections 15 (3) and 16 (3) of the Accounting Act, respectively]. According to the objectivity principle, all items of accounting must exist in reality, and they must be identifiable and substantiated. It comes from the illegal nature of bribery that it is not evidenced by documents. Of course, expenses relating to it cannot then be accepted for accounting and tax purposes. Given the accounting (and tax) principle of the substance over form, illegal events appearing in the guise of honest actions are open to challenges as well, whether related to commercial parties, a bank or the Revenue.

The non-deductibility of the bribes paid to foreign officials is contrary to the tax-law principle still followed in some countries that all expenses associated with earning taxable income should be taken into account for tax purposes either as a deductible expense or as a capitalised expenditure, provided that payments are properly documented. In Hungary, actions that are in breach of the law prescribing the public interest must be annulled. In accordance with the Hungarian Civil Code, the contracts specifying objectives not consistent with the law are null and void. So documentation is not enough: tax-related expenses must certainly arise from actions that are not in violation of law. The non-recognition of the bribery expenses covered by the OECD convention on international bribery is explicitly covered by the effective Hungarian statutory fiscal laws.

In addition to the substantive law issue of non-deductibility, another question is of procedural nature. It concerns the exchange of information regarding the bribery paid to foreign officials. Countries that are parties to the OECD convention may rely on the exchange of information article of bilateral double taxation conventions. National tax authorities are bound by the articles on the exchange of information and mutual assistance in bilateral income tax treaties. A major weakness of double tax conventions is that contracting parties are not guided in detail as how to implement treaties. Hungary is no exception to this. Besides, there is a multilateral treaty sponsored by OECD and the Council of Europe on the exchange of tax information. It is complemented by regulations on the EU level as

well. Hungary has concluded double tax treaties with more than 50 countries. However, Hungary is not yet a party to the mentioned OECD convention.[23] For the purposes of combating international bribery, it is a problem that the exchange of information under double tax conventions is strictly confined to tax matters. So bribery can only be struck as long as it relates to fiscal liability. It is another problem that the spontaneous exchange of information is not covered by most bilateral double tax treaties.

## Data management in fiscal matters

Anti-fraud measures cannot be successful unless the legal rules on data management (keeping records, disclosure rules) and on the treatment of fiscal secrecy are comprehensive, and their application is efficient. The following policy issues relevant to this area will be highlighted below:

- application for subsidies;
- reporting of cash payments;
- verifying beneficial ownership status and reporting the businesses of controlled foreign corporations; and
- conflicts between fiscal secrecy and particular public claims or banking secrecy and tax collection.

Application for subsidies, or a claim for tax recovery, is not possible in Hungary unless the applicant proves that (s)he does not have fiscal debt. However, it is dubious for constitutional purposes that claims for subsidies, or tax reclaims, are denied in case where the claimant owes either tax or social insurance contributions to the Treasury. The problem is that different claims will be matched in this case and a claim based on an independent legal title can be rejected even if the counterclaim rests on quite another legal title. Even a reclaim for local rates cannot be successful in case of the taxpayer being charged with public debt registered by the national tax authority. Nevertheless, for the time being, these Hungarian tax rules are effective.

A particular provision was introduced in Hungary with effect from 1 January 1999 on the obligation to provide information on payments in cash. According to the new law, purchasers or customers who have made payments in cash at a value exceeding HUF 5 million, or HUF 1 million between related parties, are obliged to give information on payments to tax authorities within 15 days of payment. By virtue of the earlier corporate tax law, certain amounts paid in cash were not recognised as business expenses for tax purposes, and so they were not deductible

from the corporate tax base. Also, the VAT included in the amounts under scrutiny was not deductible. However, these legal provisions were challenged before the Constitutional Court and it declared them as ones against the constitution. As a substitution for it, the new law on special reporting requirements has been adopted.

In the current Hungarian tax law, the claim of Hungarian taxpayers for international tax relief is not subject to strict legal requirements. For instance, tax exemption available under a double taxation convention or foreign tax credit will simply be used by taxpayers without being obliged to show certificates of the particulars of the acquisition of foreign income. The only burden taxpayers have to face is to substantiate their transactions during a tax audit if any. Oddly enough, the tax-exempt foreign income of Hungarian individuals shall not be indicated even in the annual tax return, provided that no Hungarian-source income is derived in the fiscal year.

The substantive law institutions of CFC legislation or statutory-law beneficial owner's test have been introduced since a couple of years in Hungary. The enforcement of taxpayer obligations relating to these institutions has been nevertheless doubtful. For example, foreign corporations active in Hungary are obliged to deliver certificates of their own fiscal residence while it is not regulated by law how they have to authenticate the fiscal residence of their owners. Formal owners may be prevented by contracts from disclosing information on their principals to Hungarian paying agents. The foreign beneficiaries may then be prevented by the Hungarian law on beneficial owners from claiming treaty benefits. Also, although there are CFC rules in effect in Hungary, there is no extended reporting requirement regarding the overseas assets held with a view to reviewing taxpayer compliance.

Tax authorities may require taxpayers in Hungary to make declarations concerning any data relevant to a tax liability. Liability can be that of a taxpayer or of a commercial associate of a taxpayer. Such declarations are limited to data either registered by taxpayers or which they are otherwise expected to know about. However, under the Tax Administration Act, any person can be required by the tax authorities to provide information concerning another person's tax liability if the person was or is in a contractual relationship with that other person, unless the provision of such information would be self-incriminating. Originally, taxpayers were obliged by the Act to make a property declaration. However, this provision was found unconstitutional by the Constitutional Court and was repealed.[24]

Tax authorities are obliged to treat data relating to taxpayers as confidential in all countries. They are allowed to use records kept by other authorities only for the purposes of identification of individual taxpayers and to assist in determining their tax liability. Problems can arise where the protection of secret information is jeop-

ardised in public hearings before the courts. In Hungarian law, there are no provisions to solve this conflict. Similarly, a conflict can develop between fiscal and banking secrecy. Under the negotiations for Hungary's accession to the OECD, the banking secrecy rules have been amended. The scope of credit institutions' obligations to keep information relevant to their clients confidential has been narrowed to improve the efficiency of tax collection. At the request of the tax authorities, credit institutions must deliver information concerning accounts they keep for clients, where the information will help initiate a tax audit or assist tax authorities with tax collection. When Hungarian tax authorities are required to comply with requests for information by foreign tax authorities in relation to foreign tax liabilities, banking secrecy is also suspended.

**Approximation of taxes, lump-sum tax, advance rulings**

Presumptive taxation is a controversial topic in all countries. Although it seems to be necessary for the Revenue authorities in exceptional cases to invoke non-traditional means of tax collection, the re-assessment of the tax base, or even to impose tax on a fictitious basis, may go beyond what is tolerable in the light of the rule of law. It is another opportunity for the tax authority to review, or even disregard, taxpayer records where advance rulings are issued. In contrast to the fictitious imposition of tax during a tax audit, in the case of advance rulings the tax authority's alternative decision about tax liability is taken precisely upon the taxpayer's request.

In Hungary, where taxpayers fail to enter their names on the fiscal register, or are found on a tax audit to have incorrect tax returns, the Revenue commissioners may estimate the relevant tax liability. This can be a breach of the principle of the rule of law because the usual methods and basis for calculation of liability are omitted. Approximation of tax liability can be justified when there is insufficient evidence of tax liability. Although it is not explicitly regulated in Hungarian law, estimating taxable income is obviously an issue of the quantity of tax and not the quality or type of income. This means that it is permissible to estimate the amount of taxable income when none has yet been calculated. But tax authorities may not use approximation to reclassify income. In making an estimate, tax authorities may rely on a comparison between the taxpayer and other taxpayers carrying on similar activities under similar circumstances. When an estimate is made, the burden of proof shifts to the taxpayer, who has to prove that any estimate is incorrect.

If necessary, Hungarian Revenue commissioners not only estimate tax liability but, where taxpayers fail to inform the tax authorities that they have commenced taxable activities and their tax liability can only be determined by approximation,

they may do so by imposing lump-sum tax. The tax is determined assuming activities have been carried on for twelve months and based on similar activities carried on by other taxpayers under similar circumstances. There are doubts as to the constitutionality of estimating tax liability and, in particular, where estimation is used to determine lump-sum tax. As the approximation of tax liability and the determination of lump-sum tax are parts of a tax audit process, they may be challenged before the courts.

Hungarian law permits tax assessment in certain circumstances based on advance rulings. Increasingly, in the fiscal law area, there are no ready-made answers as to how the substantive law applies to transactions between different parties. Presumably, the legislature does not intend to provide such answers, as fiscal tribunals may rely on tax compromises between taxpayers and the Revenue commissioners in the form of advance rulings. Although rulings only have binding force on the parties of specific cases, they can eventually serve as a starting point for later decisions. With the development of rulings, problems that cannot be solved at the level of substantive law have been moved into the sphere of procedural law, where the conflicting interests of the fiscal authority and the taxpaying community can be settled on an individual-case basis.

In characterising the practice of providing advance rulings in a country, the following questions are relevant:

- Is there a statutory basis for rulings?
- Is a Revenue authority obliged to issue a ruling upon request or is it discretionary?
- To whom is a ruling addressed?
- Is a ruling binding only on tax authorities or on the courts as well?
- What is the deadline for tax authorities to provide rulings?
- Are there charges for requesting a ruling?
- Is a taxpayer entitled to appeal against a ruling?
- Are rulings made public?

It is also important to know the scope of the application of advance rulings. There are two major areas where rulings are used. Taxpayers may file for a ruling to interpret the law in individual cases, or they can request an exception to the law to the extent that the Revenue commissioners substitute lump-sum tax for the regular tax. In the latter case, often a deemed assessable income is used to assess tax.

The practice of issuing advance rulings is deeply rooted in Europe in The Netherlands' tradition. Taxpayers may invoke advance rulings in Germany, as well. However, in contrast to The Netherlands, lump-sum tax cannot be substituted for regular tax. Hungary has been influenced by the German practice. In Hungary, the

right to file for an advance ruling has only been in place from 1996. According to the effective law, at the taxpayer's request the Finance Ministry must assess any tax liability by specifying the taxable income and the tax payable based upon the facts presented by the taxpayer. Since rulings have no retrospective effect, they may not be used for any kind of tax amnesty. A Hungarian ruling is binding on the Revenue commissioners (but not on the courts) in the specific case to which the ruling relates, provided the facts have not altered. There is no special deadline for the Ministry to give a ruling, as the general 30-day deadline applicable to a public administration procedure is effective.

## Taxpayer rights and obligations in a changing world

Taxpayer rights can only be interpreted correctly in close connection with fiscal liabilities. Tax liability consists of the very obligation to pay tax and obligations of administrative nature associated with it.[25] The liability to pay tax is in a jurisdiction established on the rule of law and bound to a procedural system of authorities and clients, strictly regulated by law. While contributing to the public, taxpayers as citizens may, in turn, review through a parliamentary mechanism how the taxes paid by them are used by the government in a country. In general terms, rights are to be interpreted in the national system of a state that operates in a valid legal order. State authority, as regulated by law, is in a personal aspect extended to citizens while, in an objective respect, it applies to the legal order effective in the national territory. In a personal respect, the legal order of a country is manifested in the rights of citizens that can be exercised in a passive, active and negative sense. Namely, in the light of a valid legal order, human behaviour emerges

- in being subjected to legal norms; this is the case of the obligation to obey the law, discussed above, that can be seen as the passive aspect of individual rights and obligations of constitutional nature;
- in a share in making norms (participating in law-making) or in a share in benefits provided by public bodies (use of the services provided by governmental agencies); this is the active aspect of rights of constitutional significance; and
- in the freedom enjoyed vis-à-vis legal norms, or rather the state itself (that is, the state forbears from interfering with private affairs); this is the negative aspect of constitutional rights, broadly speaking.

Accordingly, in examining rights to be interpreted in a constitutional order, the component parts of being legally subjected (to norms), of having constitutional

rights (to take part in law-making or to use public services) and having fundamental freedoms (to be tolerated by the state) can be identified (Kelsen 1928, 150).

In the context of taxpayer rights and tax legislation, the problem of the conflict between the letter and the spirit of law arises apparently. Taxpayers may be required, on the one hand, to exercise their rights in accordance with tax laws as well as in good faith (prohibition of *fraus legis*). On the other hand, taxpayers should be creative in implementing legal rules. Relying on efficient economic decisions, businesses should not await instructions coming from high authorities; for example, they may not expect subsidies or fiscal incentives that may distort market competition. Instead, they themselves should be able to affect their environment while, ideally, seeking for maximum benefit both for themselves and the society.

In the light of the exercise of rights in good faith as well as efficiently, taxpayers are entitled on the one hand to enjoy the fair treatment of tax authorities, on the other hand to use the facility of a legal system that tax liabilities should be prescribed in proper laws. In other words, tax rules should be correct for professional purposes, tending in particular cases to the ideal of the right law (as discussed above). Hence, in addition to the general requirements of valid legislation, a tax law should be promulgated properly, the determination of tax liability should be clear, there should be no provisions contradictory to each other, tax rules should not have retroactive effect to the detriment of taxpayers, etc. As an example for the fair treatment requirement, the principle of "richtige heffing" can be raised from the Dutch practice. It means the fair and equitable imposition of tax and relates in general to the requirement of the proper administration of law (fiscal obligations shall be enforced in a just and fair manner). This principle is applicable in The Netherlands even if there is no scope for policymaking due to lacunae to fill, or there is no explicit conflict between the decision of an authority in administering law and the statutory-law provisions relevant to a case (Sommerhalder – Pechler 1998, 320; Bentley 1998, 29).[26] The requirement of the proper implementation of law appears in the European Union as the right to legal certainty. This is the legitimate expectation principle that has been recognised in practice, although it is not covered by statutory law. Taxpayers' rights emerge in recent international practice as integral part of human rights to be protected.[27]

In the age of globalised economy and electronic commerce, there is a conspicuous contradiction in that business has become more international while tax rules are still enforceable within the borders of nation-state jurisdictions. Cross-border business transactions call upon fiscal law questions fully to be answered in a genuine international context while the application of tax rules still heavily relies on the separate procedures followed before national tax authorities as regulated by domestic laws. Under these circumstances, it is of particular importance to strike untaxed economy.

## Tax administration and anti-avoidance legislation

At first glance, the statement that it is good to pay taxes seems surprising. However, one can agree with this statement, provided that not only the fiscal burden arising from the obligation to pay tax is taken into consideration, but also the maxim of certainty as drafted by Adam Smith. People pay taxes because of the obligation to do so. It is still better to pay taxes than tributes. The distinction between taxes and tributes was widely experienced in post-communist countries where the state enterprises, as the main constituents of the national economy, were actually not subject to taxes but profit remittances that the government obtained by coercion from time to time.

In contrast to this arbitrary approach, taxes must be based on solid legal foundations. It is then not possible for the authorities to require more taxes or to claim them earlier than is prescribed by law. In any tax system, one of the greatest benefits for taxpayers is that tax laws are binding not only on taxpayers but also on the tax authorities. The rule of law in the field of taxation and the provision of extensive taxpayer rights depend very much upon a well-established order of tax administration.

A legal norm (not to mention legal provisions or even particular laws) is more than a set of letters. The implementation of laws assumes therefore prediction and sovereign decisions. Doing research on the right law, Stammler quotes Paulus (the apostle), as follows: "το γραμμα αποχτεννει, το δε πνευμα ζοοποιει" (approximately: letters are dead while the spirit is living). Legal provisions imply principles, reflecting substances emerging behind the letters of laws. There can be conflicts between the letters and the spirit of laws. They can quite frequently occur in fiscal matters. Examples for this may amply be provided in all jurisdictions. The typical subject of conflicts is tax avoidance. It may well appear to be legal. This is first because it is part of the freedom of entrepreneurs to optimise their activities, including tax considerations, secondly because tax avoidance cannot be struck in the absence of the actual infringement of particular legal rules in effect. Based on its true nature, tax avoidance is, however, to infringe the integrity of the legal order in a country. Focusing on the economic (or legal) substance of business transactions rather than on the legal forms as applied by parties, tax avoidance is the abuse of law that may be challenged.

### *Anti-avoidance rules in Hungary*

Anti-avoidance rules in Hungary are enacted by legislation, i.e., they are typically not developed in the judicial practice. Hungary's anti-avoidance rules contain

both general and special rules. The first anti-avoidance rules have been completed and amended by the legislature, based on the judgements of the judicial practice since the mid-1990s. The current system of anti-avoidance rules is still not complete, and the rules require further refinement (Deák – Földes 2002, 313). The forms of the general anti-avoidance rules are:

– classification of contracts and related actions based on their true nature (disregard of simulated contracts);
– the principle of the proper use of rights (prohibition of the abuse of law); and
– the taxability of income from illegal acts.

These forms are regulated by the procedural tax law in Hungary.

Being drafted in various acts, major forms of special anti-avoidance rules in Hungarian law are:

(1) Both the corporate tax law and the procedural tax law contain rules on related parties. They prescribe the use of arm's length principle between related parties.
(2) In accordance with the transfer-pricing rules, the arm's length principle is also set down in the value added tax law in respect of non-independent parties.
(3) According to the Hungarian statutory thin-capitalisation rules, the portion of interest paid on a loan received by a Hungarian corporate taxpayer from a non-Hungarian-resident financial enterprise in excess of three times of the company's equity, is not deductible for tax purposes.
(4) By virtue of the Hungarian statutory rules on controlled foreign corporations, dividends are normally excluded from the corporate tax base, but they are not excluded if the dividends are received from a controlled foreign corporation. The main CFC sanction is that capital losses suffered in relation to holdings in a CFC may not be recognised as expenses for Hungarian corporate tax purposes, whether they are accounted for as the write down of existing holdings or as the loss sustained on the disposal of the shares in a CFC.
(5) The anti-avoidance rules, in connection with the strict approach of the individual income tax law and the corporate tax law to the fiscal law treatment of expenses made for other than business purposes, are also worth mentioning.

*Classification of contracts based on their true nature*

According to Section 1 (7) of the Hungarian Tax Administration Act, contracts, transactions and similar acts must be classified based on their true nature (the legal

substance of the transaction under review must prevail over the legal form as applied by parties). This principle as enshrined in the law has been modelled on the German and Austrian legislation. The Hungarian law principle conforms to the English and American principle of the substance over form, which may also be referred to in the Hungarian Act on Accounting [Section 16 (3)]. This principle creates a link between the divergent means of regulation in civil law and tax law, by providing for that, in accounting for particular business events, reference must be made to the true nature of contracts, transactions and related acts. The tax law principle of Section 1 (7) of the Tax Administration Act is most often used concerning covert and artificial contracts. It may, however, also be used regarding other transactions (e.g. unilateral transactions). In applying the principle for the classification of transactions according their true nature, one has to examine whether a transaction between the parties, based on its genuine characteristics, matches to the characteristics which were presented by the parties. The authorities may not change, substitute or supplement factual elements. The relationship between the parties may not be modified if its true economic nature matches to the outward form of the transaction under review. For example, several court decisions have been rendered which were based on the true nature of contracts, and which re-characterised contracts, presented as finance leases but treated in fact as sales. Thus, tax deficiency assessed by tax authorities, based on re-characterisation, was approved. The courts agreed that only the rent, and not the sales price, could be deducted.

The law also states that invalid contracts and other transactions are only relevant for tax purposes to the extent they have a distinct economic result. If there is a difference between the appearance of a contract and its true nature, it is the covert transaction that must be assessed for tax purposes. Invalid (void and voidable) contracts do not become necessarily retroactively valid in the civil law sense. However, economic results can be discerned for tax purposes. A special case of the classification of contracts based on their true nature can be the tax treatment of profits from illegal acts or, using the formula of the Civil Code, acts offending morality. Tax liability is not influenced by the fact that someone's conduct (action or inaction) is illegal or offends morality [Section 1 (9) of the Tax Administration Act]. These transactions are void in the civil-law sense, but it is still possible that such transactions can have distinct economic results, triggering fiscal liability.

The principal decision of the Supreme Court in 1998[28] has definitely influenced both the implementation of law and the legislation itself. Based on certain previous individual income-tax rules, approximately 12,000 taxpayers tried to use tax allowances by making several, inter-connected contracts, specifically established in order to benefit from tax relief. The Revenue authorities rejected the use of allowances, referring to Section 1 (7) of the Tax Administration Act by alleging

the artificial nature of the transactions under discussion. In these transactions, the unconcealed and sole aim of the contract packages was to utilise tax allowance. Based on these cases, the Supreme Court made some significant rulings. It provided a guideline for identifying real and artificial transactions. Contrary to prior practice, the criteria for artificial and covert transactions were defined in a narrower sense. According to the court, the tax authorities' actions may not result in consequences contrary to the contractual will of parties, thus making certain contracts invalid, provided that the contractual will is held by parties. The Supreme Court stated: "Thus, it is not against the law for the taxpayer to make contracts as a result of which his position under the tax law will be more favourable, provided that the statute establishing the given tax allows this." This statement has also had an effect on later legislation. The Court disregarded, however, the contracts mentioned above, which were established with the specific purpose of avoiding tax and which had not any economic results or aims aside from the reduction of tax.

As a consequence of the Supreme Court's decision, the tax cases based on the principle on the classification of transactions according to their true nature became less frequent as the tax authorities seldom attempted to establish the tax claim on this principle, to be interpreted within the terms of the narrow definition of the Supreme Court. According to the new judicial practice, the Revenue authorities have the actual possibility to intervene, referring to the true nature of a contract, only if their decision is not based solely on the civil-law invalidity of the contract, but also on its consequences in tax law. In a legal case concerning the refund of VAT on the sale of a software distribution right,[29] the Supreme Court on the one hand did not agree with the arguments of the tax authorities that the transaction between the parties was invalid under civil law. On the other hand, the Court accepted that the invoice was not issued to reflect a real business event. Considering all circumstances relevant to the case, the Supreme Court concluded that the act had not actually occurred (the invoice was not recorded in the vendor's books, it was not included in tax returns and the tax was not paid).

### *The proper use of rights*

Soon after the quoted decision of the Hungarian Supreme Court in 1998, the tax procedural law was amended. The requirement on the proper use of rights (prohibition on the abuse of law) has been established in the law [to reflect the economic substance prevailing over the legal form as defined by Section 1A (1) of the Tax Administration Act]. According to this principle, rights must be used properly in fiscal matters. In consideration of the application of tax laws, a contract or other transaction with a purpose of circumventing the provisions of tax law is not con-

sidered as the proper use of rights. In these cases, the tax authorities may establish (basically, estimate) tax with regard to all circumstances, they assess especially tax liability that would have been resulted if there had been no abuse of law. The Supreme Court had already referred in extraordinary cases to the principle of the proper use of rights even before it was enacted as part of Hungarian legislation, but without defining precisely the conditions for applying this principle. In particular, lacking an explicit legal provision, it only existed as a general principle.

Based on this provision of law, the decision of tax authorities does not concern the contractual relationship of parties, only its consequences in tax law. Tax authorities need not prove the invalidity of a contract or other transactions, as is the case in respect of the principle on the classification of contracts based on their true nature. Rather, the Revenue authorities must only prove that the sole purpose of the transaction under dispute is to utilise tax advantages, i.e., that it has no genuine business purpose. The Revenue authorities must prove that the transaction is economically not reasonable. This does not necessarily mean that they must prove there is no economic advantage, aside from the tax advantage, that would be available for either of the parties.

*True and fair view principle*

In connection with the introduction into Hungarian law of the requirement that true and fair view ("TFV") of the financial position of a business must be given in a particular period of accounting [Section 4 (2)(4) of the Accounting Act], and with regard to the protection of tax base, the Corporate Tax Act prescribes that even if taxpayers depart from particular accounting rules in order to give true and fair view in a fiscal year, this deviation may not result in decreasing fiscal liability [Section 1 (5) of Corporate Tax Act]. Although under Hungarian fiscal law the first step of determining the taxable profit is considering accounting profit, the corporate tax law contains restriction in many points. As a result of it, while calculating the tax base, taxpayers widely deviate from accounting procedures. In the current case, the tax law prescribes deviation from accounting not in detailed questions but in respect of the "principle of principles", although the TFV principle cannot be enforced but in a strictly regulated procedure, in forced association with the company's appointed auditor. It can be questioned whether, providing for deviation from the main accounting principle, tax legislator has not proceeded too far.

Accounting legislation can in particular be spoiled by the assumption, whether disclosed or not, that application of the TFV principle may support taxpayers in tax avoidance. Even if it were possible by way of the restricting provision of Sec-

tion 1 (5) of the Corporate Tax Act to close a loophole, this does not necessarily mean that it would otherwise be possible to make the corporate-tax system devoid of leakage. For instance, a particular challenge the legislator has to face may be to recognise under fiscal law the expense of deferred tax. While the accounting for deferred tax is not precluded, this expense is not prohibited by tax law.[30] The deferred tax may be accounted for as an expense, for example, with regard to potential capital gains in a case where accrued, but not realised, capital gains are to be shown in books.

The conflict between the accounting and tax law is the manifestation of the conflict between the civil-law regulation, providing for the legal conduct relevant to free trade, and the particularised professional regulation connected with the extended liability assumed by the State in a country. In modern times, such conflicts cannot be spared. Yet it is only a matter of dispute that under what conditions the civil-law principles, reflecting market equilibrium (equality before the law, the sacredness of private ownership, the freedom to contract), may be restricted.

Problems may be deteriorated in cases (even if they may be justified) when the civil-law principles of free trade are restricted by non-tax law provisions. For instance, the Hungarian Accounting Act – in this respect as law fulfilling the function of vicarious particular legal regulation – provides for the accounting for finance lease, the concept of which is otherwise determined in financial law. The accounting law provision is of mandatory nature, restricting the freedom to contract. This is because in cases where features such as the financing function assumed by an intermediary, the reservation of title and the delegation of the risks of operation prevail, contracting parties are obliged to follow accounting provisions. For financial-law purposes, the professional law regulation made by introducing mandatory provisions on finance lease may well be justified. This is because these provisions are to protect monopoly: it is in the public interest to provide for who may be licensed to render financial services. The accounting law regulation on finance lease, made again by means of mandatory provisions, can, however, hardly be legitimised. It is all right that tax rules reflect what is in compliance with Machiavelli's idea of "ragione di stato". However, accounting legislation should be exempted from any influence of the state-centred way of thinking.

## 3. CONCLUSIONS

The two major conclusions that can be drawn from the above study are as follows. First, in a strict analytical framework, tax evasion can hardly be legitimised by civil disobedience. In a legal system where legal norms gain their validity exclusively from the legal norms proximate to them in a pre-ordained hierarchy of legal

norms, the norms of positive law – arising from legal rules, precedents or scholarly explanations – must be respected as long as they are effective. The intact system of law cannot thus be threatened from outside by the subversive values of morals or the natural law. In this respect, it is indifferent how the development of the sense of duty to obey the law is explained. It can be supposed either as a faculty inherent in all human beings or as a *prima facie* duty.

Loyalty, a micro category like the obedience of law, is not helpful in exploring particular legal meanings. Financial markets cannot afford, however, not to rely on fiduciary accounts, and thus property rights appear in the abundant layers of asset management. Loyalty, contributing to the segmentation of law and to the dispersion of legal norms, is an obstacle to developing transparent legal structures. Under such circumstances it is more difficult to decide and explain from case to case if the applicable law is respected.

Secondly, what is theoretically explicable by a coherence theory is followed in the fiscal-law practice (where alternative forms of tax assessment can be developed) in terms of presumptive tax assessment or advance rulings. Although these kinds of bargaining can hardly be placed in the set of traditional legal institutions, they can be verified if taken separately. It is only important to seek for the coherence of the particular norms applicable to the particular situation.

It also comes from the coherence-based approach to law that legal arrangements – based on similar formal institutions – may be significantly different in different real-world situations. While coherence in these micro relations can be ascertained, it is necessary to renounce looking for the rule of law that cannot suit but for the macro relations of the legal order, where instability in meaning and inconsistency in the structure of legal sources cannot be avoided. There should be legal cases in which no legal norms are inherent that could be guiding as such for other cases as well. In the holistic view of law, one has to acknowledge that micro-level solutions are not necessarily the component parts of the legal system as a whole. Instead, there are units of the developments of law, coherent in themselves, albeit loosely connected with each other. In the context of a spider's web, sporadic tax rulings or other products of tax law bargaining may, or may not, be relevant to other arrangements.

Tax-law principles like the non-recognition of simulated contracts or the prohibition of the abuse of law stay afloat and tend to lose their applicability to real-world cases. Instead, they will be simply replaced by aspirations to show coherence in distinct cases. What is then important for taxpayers is not to speculate over the possible outcome of the anticipated transactions. It promises more success if they strive for elaborating a coherent theory to interpret their case to be reviewed. As a last resort, advance rulings may be filed in order to reach certainty in an individual case.

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## NOTES

[1] For the interpretation of the theory of Rawls on the implied social contract, see Kolm (1993, 448 and 450). Hart offered a fresh argument in support of the duty of obedience, based upon his formulation of what has come to be known as the principle of fair play: "… when a number of persons conduct any joint enterprise according to rules and thus restrict their liberty, those who have submitted to these restrictions when required have a right to a similar submission from those who have benefited by their submission" (Hart 1955). See also the explanation of the theory of Hart with Smith (1996, 466).

[2] Ross suggested (in *The Right and the Good,* Oxford: Clarendon, 1930) that a separate duty to obey the law could be identified: "Thus ... the duty of obeying the laws of one's country arises partly … from the duty of gratitude for the benefits one has received from it; partly from the implicit promise to obey which seems to be involved in permanent residence in a country whose laws we know we are expected to obey, and still more clearly involved when we ourselves invoke the protection of its laws …; and partly (if we are fortunate in our country) from the fact that its laws are potent instruments for the general good."

[3] "The ethic of loyalty brings to bear an historical self: impartial morality derives from the universality of reason or of human psychology. The former is pitched to humans as they are; the latter, to the spiritual aspirations of humans as they might be" (Fletcher 1996, 531).

[4] In the process of the state's ideological planning, "meaning" is an increasingly scarce resource: "The resource of 'value', siphoned off by the tax office, has to make up for the scanty resource of 'meaning'. Missing legitimations have to be replaced by social rewards such as money, time and security" (Habermas 1995, 154).

[5] The macro and micro aspects of the social structure appears with Bourdieu in a way somewhat different from the above, in the instance that he distinguishes between the objective and subjective world of a society: "the perception of the social world is the product of a double structuring: on the objective side, it is socially structured because the properties attributed to agents or institutions present themselves in combinations that have very unequal probabilities ... On the subjective side, it is structured because the schemes of perception and appreciation, especially those inscribed in language itself, express the state of relations of symbolic power. … Together, these two mechanisms act to produce a common world, a world of commonsense or, at least, a minimum consensus on the social world" (Bourdieu 1995, 329).

[6] The first principle of justice prescribes that each person should have an equal right to the most extensive scheme of basic liberties. The first preliminary condition of the second – the difference – principle of justice denotes commensurability: differentiation must be operative in the sense that the goods allocated are comparable with each other (Rawls 1980, 201–203).

[7] Russel Hardin (1996, 469) emphasised various limitations of the market mechanism and argued that firms can be understood in terms of market failures which arise under conditions of externality, economies of scale and information asymmetries. See for this also Foss et al. (1996–2000, 633).

[8] In the gradual structure of legal order, law-making and the implementation of law are not opposed to each other absolutely. Instead, the border-line between them is relative (Kelsen 1925, 233–234).

[9] The pure legal theory is formal in the sense that the particulars dominant in a certain case may be disclosed in cognition. In contrast, a formalistic approach is simply a one-sided way of presenting things as a specific subject of cognition that leads to knowledge of restricted validity (Stammler 1926, 41).

[10] "Richtiges Recht ist ein positives Recht dann, wenn es in seinem bestimmten Fordern und Verneinen die Rücksicht auf den einheitlichen Grundgedanken des rechtlichen Wollens überhaupt als wesentlichen Richtpunkt innehält" (Stammler 1926, 45).

[11] For example, right law may be discovered in the income tax regulations effective in a country at a certain time. In modern income tax law, the comprehensive concept of income, as drafted by Schanz, Haig and Simons, is recognised as a benchmark of the idea of optimal taxation. Particular income tax law provisions may deviate from this ideal in certain details. However, they must be consistent with the essence of the Schanz–Haig–Simons concept of income reflecting right law. Clearly, right law is not a matter of black-and-white judgements. It is rather something that can only be ascertained by theoretical analysis, the results of which may be then disputed.

[12] The introduction of the Greek terms as quoted above may be ascribed to Aristotle.

[13] Of course, international law is part of legal order in the same way as national law, even if its provisions cannot be enforced so simply as is usual in the case of national law provisions (Kelsen 1928, 125). With regard to the requirement of unity in legal order, the declaration of either national or international law to be superior to each other is unjustifiable (*ibid.,* 121). Remarkably, sovereignty appears both in domestic and international law. However, to present sovereignty in dual terms is nothing more but to scratch the surface (*ibid.,* 107). In contrast to public opinion, one can state that sovereignty is no higher authority in the political system in a country. Instead,

it is manifestation of a distinct normative structure. Sovereignty can be considered in a country as the exclusivity of the legal order, free from contradictions (*ibid.,* 104). To identify the state with the state power, and state power with a certain organ of a state, leads to misconception, or even abuse, of sovereignty (*ibid.,* 115). The idea of Machiavelli on "ragione di stato" is logical but does not promote the unity of law (*ibid.,* 90).

14 According to Stammler, in the light of the principle of *pacta sunt servanda,* the only conduct of parties that can be treated as lawful is that from which right law emanates. A party's conduct that is not in accordance with right law, or is not consistent with the basic idea of law revealed in legally binding provisions, results in breaching the contract in question, in general terms, in violation of law (Stammler 1926, 309–310).

15 Nevertheless, it is doubtful enough – for example in the case of an enterprise, which resides in one treaty country and keeps contacting a company that resides in another treaty country through a company that operates in a tax haven, and that tax haven company is related to both of the above companies – whether one contracting state, during a tax audit initiated against the company residing therein, may request the other country for information of a contract which the company residing in that other contracting state concluded with the tax haven company.

16 I am not arguing here that accounting principles should not deviate from tax principles at many instances because they seek to achieve different purposes, albeit they may start with a common base for practical reasons.

17 "The behavioral starting points in Williamson's theorizing are, first, Herbert Simon's concept of bounded rationality, which produces contractual incompleteness and a need for adaptive, sequential decision making, and, secondly, opportunism, defined as 'self-interest seeking with guile', which has the implication that contractual agreements need various types of safeguards, such as 'hostages' (for example, the posting of a bond with the other party). … Given bounded rationality and uncertainty, these are determined by what has increasingly become the central character in Williamson's analysis, namely asset-specificity. Assets are highly specific when they have value within the context of a particular transaction but have relatively little value outside the transaction. This opens the door to opportunism" (Williamson 1996); for further explanation: Foss et al. (1996–2000, 640).

18 *Regina v Charlton, Cunningham, Kitchen and Wheeler,* Court of Appeal, Criminal Division (1995), Simons Tax Cases (1996) STC 1418. For further explanation, see Bridges et al. (1999).

19 Legf. Bír. Bf. I. 1249/1992; in: 41 *BH* 1993, case No. 660.

20 *Council Directive 91/308 EEC,* OJ L 166, 28/06/91, p. 77.

21 See, in particular, as follows:
- OECD convention on combating bribery of foreign public officials (signed in Paris on 26 May 1997);
- revised recommendation on combating bribery in international business transactions (adopted by the OECD Council on 23 May 1997);
- recommendation on the tax deductibility of bribes to foreign public officials (adopted by the OECD Council on 11 April 1996); and
- implementation of the 1996 OECD recommendation on the tax deductibility of bribes to foreign public officials (Report by the Committee on Fiscal Affairs to the OECD Council at Ministerial level, 26 May 1997).

22 The anti-fraud measures of the EU are associated rather with tax evasion than bribery. However, with regard to the close connection between them, their legal sources are here mentioned as follows:
- Council Regulation 2988/95 (OJ L 312, 23.11.1995) on the protection of the Community's financial interests; Convention on the protection of the Community's financial interests; First

Protocol to the Convention relating to corruption to the detriment of the Communities' financial interests, signed on 27 September 1996;
– Council Regulation of 11 November 1995 concerning on-the-spot checks and inspections carried out by the Commission; Council Regulation 2185/96 (OJ L 292, 15.11.1996); and
– FISCALIS programme with a view to preventing indirect tax fraud in the EU [COM (97) 175 final as amended by COM (97) 621 final].

[23] Drafted by the OECD and the Council of Europe in 1988; it took into force on 1 January 1995. There is a set of provisions inserted for 2002 and 2003 into the Hungarian Tax Administration Act (Sections 48A-48O) to enable Hungary to implement the Mutual Assistance Directive (Council Dir. 77/799 EEC, OJ L 336, 27/12/1977, p. 15) and Council Directive 2001/44/EC of 15 June 2001 amending Directive 76/308/EEC on mutual assistance for the recovery of claims resulting from operations forming part of the system of financing the European Agricultural Guidance and Guarantee Fund, and of agricultural levies and customs duties and in respect of value added tax and certain excise duties (OJ L 175, 28/06/2001, p. 17). For Council Directive 76/308/EEC, see OJ L 073, 19/03/1976, p. 18. The inserted provisions will enter into force on the date of the EU accession.

[24] No. 21/1993 (2.IV.) AB resolution.

[25] A tax law relationship (Steuerrechtsverhältnis) may comprise a legal relationship of fiscal debt (Steuerschuldverhältnis) or a legal relationship of various fiscal obligations (Steuerpflichtverhältnis). The former is of pecuniary nature, the latter is without financial outcome (Tipke 1987, 135).

[26] Commentaries are provided with reference to specific legal cases. The German civil-law requirement that rights must be exercised in good faith (Section 242 BGB) is to be extended to tax law as well (Tipke 1987, 598). An example for this is the legally binding information of taxpayers to be delivered by tax authorities for the future in terms of formal resolutions, at the end of a tax audit [Sections 204–207 verbindliche Zusage, *Abgabenordnung vom 16. März 1976* (BGBl 1977 I S. 269 mit späteren Änderungen)].

[27] *European Convention on Human Rights* (Rome, 4 November 1950), Article 6 (1). Interestingly, it appears from the Funke decision made by the European Court of Human Rights (Funke v. France, 25 February 1993, Series A No. 256-A, 82/1991/334/407) that, in a customs investigation case, commissioners may only take measures that are strictly proportionate to the aim pursued in the procedure (Bentley 1998, 23).

[28] See Decision of the Supreme Court No. 1/1998 KJE.

[29] Legf. Bír. Kfv. III. 28.049/1997, in: 46 *BH* 536/1998.

[30] According to IAS 12 (11), expenses arising from tax payment must relate – at least in part – to the accounting period in which the particular economic event, resulting in fiscal liability, takes place. (See also Alexander – Nobes 1994, 205.)